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Nos. 79 and 80

# In the Supreme Court of the United States

OCTOBER TERM, 1952

MARTHA L. ALISON

v.

THE UNITED STATES OF AMERICA

THE UNITED STATES OF AMERICA

v.

STEVENSON-CHISLETT, INC.

On Certificates from the United States Court of Appeals for the Third Circuit

## BRIEF FOR THE UNITED STATES



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## BRIEF FOR THE UNITED STATES

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### OPINIONS BELOW

The opinion of the District Court in *Alison* v. *United States* (No. 79) (R. 5-8) is reported at 97 F. Supp. 959. The opinion of the District Court in *United States* v. *Stevenson-Chislett, Inc.* (No. 80) (R. 3a-11a) is reported at 98 F. Supp. 252. The Court of Appeals did not issue an opinion.

## JURISDICTION

The Court of Appeals certified questions of law on which it desired instructions. The certificate in the *Alison* case (No. 79, R. 8-11) was filed on May 3, 1952. The certificate in the *Stevenson-Chislett* case (No. 80, R. 13-16) was filed on May 23, 1952. On June 9, 1952, orders were entered by this Court requiring the entire record in each case to be sent up so that the entire matters in controversy might be decided. (No. 79, R. 11; No. 80, R. 16.) The jurisdiction of this Court is conferred by 28 U.S.C., Sec. 1254 (3).

## QUESTIONS PRESENTED

1. In the *Alison* case the taxpayer discovered in 1941 that she had suffered embezzlements over a period of prior years. When the embezzlements were discovered, the statute of limitations prevented the filing of refund claims for some, but not all of the taxable years in which the embezzlements had occurred.

The question is whether, notwithstanding the fact that no embezzlement took place in 1941, the taxpayer can be allowed under Code Section 23 (e) to deduct in her income tax return for that year the entire net amount embezzled in previous years.

2. In the *Stevenson-Chislett* case, the taxpayer discovered in 1945 that it had suffered embezzlements over a period of prior years. The precise years in which the embezzlements took place were not known and, as found by the District Court, it was a practical impossibility to ascertain that fact.

The question is whether, notwithstanding the fact that no embezzlement took place in 1945, the taxpayer can be allowed under Code Section 23 (f) to deduct in its income tax return for that year the entire net amount embezzled in previous years.

## STATUTE AND REGULATIONS INVOLVED

The applicable provisions of the statute and regulations involved are set forth in Appendix A, *infra*, pp. 54-58.

## STATEMENT

### ALISON CASE

In the *Alison* case the facts were stipulated (R. 2-4), and were found by the District Court in accordance with the stipulation (R. 5-6). The pertinent facts may be summarized as follows:

The taxpayer, the owner of certain real estate and securities, had entrusted control and possession of the property to J. W. Cree, who acted as her business agent and adviser. There was no written agreement between the taxpayer and Cree with regard to this property, and no accounting was ever requested of or given by him. The taxpayer's account, as well as that of other persons, was carried in a separate set of books called the "J. W. Cree, Jr., Trust Account," the funds of which were commingled with his personal funds. The taxpayer's securities were carried in the name of Cree. (R. 3.)

Cree died in 1941. Shortly after Cree's death the taxpayer found that there was due her in cash the sum of $30,155.37, which was not available for payment to her because Cree had commingled the funds with his own and had used them for his personal benefit. The taxpayer was the largest creditor of Cree's estate. Since the estate did not possess sufficient funds to satisfy all creditors, an agreement was reached as a result of which the taxpayer incurred a net loss of $21,804.90. Pursuant to the agreement, she received a cash payment of $3,380.95 in 1942 from a creditor of Cree's estate. (R. 3.)

The amounts taken by Cree and the amounts paid back, as shown by Cree's books, are as follows (R. 4):

| Years | Amount Taken | Amount Paid Back | Net Amount Embezzled |
|---|---|---|---|
| 1931 | $ 8,000.00 | $ 2,000.00 | $ 6,000.00 |
| 1932 | 500.00 | ---- | 500.00 |
| 1934 | 2,000.00 | ---- | 2,000.00 |
| 1935 | 3,000.00 | ---- | 3,000.00 |
| 1936 | 4,800.00 | 500.00 | 4,300.00 |
| 1937 | 2,000.00 | ---- | 2,000.00 |
| 1938 | 4,950.00 | 1,450.00 | 3,500.00 |
| 1939 | 4,300.00 | ---- | 4,300.00 |
| 1940 | 1,500.00 | ---- | 1,500.00 |
| 1941 | ---- | ---- | ---- |
| | $31,050.00 | $ 3,950.00 | $27,100.00 |
| Add: "Uninvested principal in principal (stock) Acc't | | | 3,055.37 |
| Total uninvested cash embezzled | | | $30,155.37 |

During this period, Cree enjoyed substantial credit and had a reputation for meeting his bills. The taxpayer had no reason to suspect that her funds were being embezzled by Cree and she had

no knowledge of the embezzlements until after his death. (R. 4.)

The taxpayer, claiming an additional deduction on account of the $21,804.90, filed a refund claim for 1941 (R. 2). The Commissioner rejected the claim on the ground that the loss was due to embezzlements attributable to the years 1931 to 1940, and did not occur in 1941 (R. 3). The District Court, in the taxpayer's suit for refund, held that the deduction was not allowable in 1941 (R. 6-8). The Court of Appeals, after hearing the case, ordered a rehearing before the court *en banc*. The six judges who heard the case were equally divided on the issue and certified the question to this Court which, thereafter, ordered that the entire record be sent up. (R. 10-11.)

STEVENSON-CHISLETT CASE

In the *Stevenson-Chislett* case the following facts, based on the pleadings and proof, were found by the District Court:

In the early part of 1945, during an audit of the books of the taxpayer corporation, a discrepancy was discovered between the accounts receivable control account in the general ledger and the total of the individual accounts receivable as of December 31, 1944. Further investigation established the exact amount of the discrepancy as being $21,675.37. (R. 4a.)

This amount represented funds embezzled from the taxpayer by an unknown person or persons over an unascertained number of prior years. The taxpayer's cashier-bookkeeper over a period of several years had been manipulating the books and records to cover up cash shortages. This was done by accumulating for several months credit slips of individual accounts receivable. Credit slips were posted in later months, but there were usually several months of credit slips unposted. These manipulations were aided by an officer of the corporation. This, together with the silence of other employees who knew of or suspected the manipulations, resulted in the taxpayer's failure to discover the shortage until 1945. (R. 4a.)

The District Court concluded that the series of embezzlements, the nature of the records available, and the reluctance of the persons involved or suspected to render cooperation, made it a practical impossibility for the taxpayer to ascertain the exact year or years in which the succession of shortages occurred. It also concluded that an attempt to segregate the exact year or years of the shortages would have required a very detailed and extensive audit, and investigation, with no assurance that it would be successful, and that the taxpayer had made a reasonable effort to ascertain the dates of the embezzlement and the identity of the guilty party. (R. 5a.)

The taxpayer filed a refund claim for the calendar year 1945 asserting the right to deduct in that year the amount of $20,925.20 on account of an embezzlement loss which had been discovered in that year. After the Commissioner failed to grant the claim, a suit for refund was instituted in the District Court. (R. 3a-4a.) The District Court held that, although embezzlements had taken place in prior years, the loss was deductible in 1945 when discovered (R. 5a-11a). The Court of Appeals, after hearing the case, ordered a rehearing before the court *en banc*. The six judges who heard the case were equally divided on the issue and certified the question to this Court which, thereafter, ordered that the entire record be sent up. (R. 13-16.)

## SUMMARY OF ARGUMENT

A. Code Section 23 (e) and (f) grants a deduction for losses sustained during the taxable year. From a very early time this has been administratively construed to mean, in the case of embezzlement losses, that such losses are sustained and are deductible in the year in which the embezzlement occurs. A long line of judicial decisions over the course of years has confirmed this interpretation.

The year in which an embezzlement loss is discovered is not the year in which the loss is sustained. Even though the discovery is too late to permit the filing of amended returns for claiming the loss in the year in which sustained by the

embezzlement, or even though it is difficult or impossible to ascertain the exact year of the embezzlement, there is no statutory authority under which the earlier loss can be deducted in the later year when the discovery is made.

B. Code Section 43 does not constitute a statutory authorization for permitting an embezzlement loss to be deducted in a taxable year subsequent to the year in which the loss was sustained. That section, which is concerned with a clear reflection of income, was never intended to permit the deductions of one year to be taken in another year simply because the annual accounting system is considered to result in harsh consequences to a particular taxpayer, such as when the right to the deduction is not discovered until the statute of limitations bars the deduction for the proper year, or when it is difficult to ascertain the proper year for the deduction. Indeed, since the deduction of the losses of prior years' embezzlements in the discovery year does not result in a clear reflection of that year's income, and since the aggregation of several years' losses as a deduction in a single tax year is bound to result in a distortion of income, it would subvert the function of Section 43 if it were applied to such use.

C. The Treasury Regulations which interpret Code Section 43 do not permit an embezzlement deduction to be taken in the discovery year. While

the Regulations state that an embezzlement loss is "ordinarily" deductible in the year when the embezzlement is sustained, the word "ordinarily", when analyzed in the context of the history of the Regulations, does not imply that the loss may be deducted in the discovery year. The provisions of the Regulations as a whole and their administrative interpretation preclude any other conclusion. Further, since Code Section 43, which the Regulations interpret, is designed to achieve a clear reflection of income, it is plain that the Regulations were not intended to permit a distortion of income by allowing the deduction to be taken in an improper year.

D. The fact that Congress has acted to mitigate the statute of limitations in certain limited circumstances which are not applicable here illustrates why the statute of limitations cannot be circumvented by permitting embezzlement losses of barred years to be deducted in the discovery year. Further, the fact that Congress, motivated by difficulties confronting taxpayers in establishing the exact year of a loss, acted to create a conclusive, statutory presumption regarding the time when certain war losses were sustained, illustrates why difficulty of proof in other circumstances does not constitute a valid reason for permitting a loss deduction to be taken in a year when the loss was not sustained. These legislative enactments demonstrate why the particular hardships of which these

taxpayers complain present problems which are properly addressed to Congress for its consideration.

## ARGUMENT

### Embezzlement Losses Must Be Deducted in the Year When the Embezzlement Occurs. The Deductions Cannot Be Allowed in a Year When No Loss Was Sustained

The question presented by the *Alison* case (No. 79) is whether the taxpayer is entitled to a loss deduction under Section 23 (e), Internal Revenue Code (Appendix A, *infra*, p. 54), for the taxable year 1941, that being the year in which it was discovered that she had suffered embezzlements during a period of years, all of which were prior to the taxable year. We believe that the question should be answered "no."

The question presented by the *Stevenson-Chislett* case (No. 80), is whether the taxpayer is entitled to a similar deduction under Code Section 23 (f) for the taxable year 1945, that being the year in which it was discovered that the taxpayer had suffered embezzlements during a period of prior years, although the actual years of the embezzlements were unknown and it was a practical impossibility to ascertain them. We believe that this question should also be answered "no."

In both cases the embezzlements took place in prior taxable periods and no losses were sustained in the years in which the loss deductions are being claimed. Because, as we view the

matter, the same basic principles are dispositive of both of these cases and require that the claimed deductions should not be allowed in the taxable years, it seems appropriate that the cases be examined together in a single brief.

**A. Code Section 23 (e) and (f) Requires That An Embezzlement Loss Be Deducted Only In the Year When the Embezzlement Occurs.**

The decision of these cases must turn on the proper construction of the statute; accordingly, we begin with the language by which Congress has conferred the right to the deduction. Code Section 23 (e) grants to individual taxpayers the right to a deduction for certain kinds of specified "losses";[1] Section 23(e)(3) (Appendix A, *infra*, p. 54), enumerates, as one of the deductible losses, those arising from "theft," a term which has been construed to include losses from embezzlements. Section 23(f) (Appendix A, *infra*, p. 54), grants to corporate taxpayers a deduction for "losses," without limitation on the nature of the loss or the manner in which incurred.[2] Congress has specified precisely when the deduction is to be taken by individual and corporate taxpayers, for each subsection applies only to "losses sustained during the taxable year."

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[1] The taxpayer in the *Alison* case is an individual, so that Section 23(e) is applicable.

[2] The taxpayer in the *Stevenson-Chislett* case is a corporation, so that Section 23(f) is applicable.

The language of Section 23 is unambiguous; it permits the deduction to be taken *only* in the year when the loss is actually sustained, and necessarily forbids the deduction from being taken in any other taxable period. Commenting on these plain words of the statute in *Boehm* v. *Commissioner*, 326 U. S. 287, 292, this Court said: "Such unmistakable phraseology compels the conclusion that a loss, to be deductible under Section 23(e), must have been sustained *in fact* during the taxable year."

Since the only operative event which took place within the taxable year in each of these cases was the taxpayer's discovery of the net amount of the embezzlement losses which had occurred in prior years, it seems inescapable that no loss has "been sustained *in fact* during the taxable year." The statute, accordingly, precludes the taxpayers from being entitled to the claimed deduction in these discovery years since they are not the loss years. There is nothing, moreover, in Section 23 or in any other section of the Code which authorizes the deduction to be shifted from the year in which the loss was sustained to the year in which discovered, or to any other year, simply because the discovery was too late to permit the deduction to be claimed in the proper taxable period, as is true of some of the years involved in *Alison*, or because the precise years of the losses may be difficult to ascertain, as is the situation in *Stevenson-Chislett*.

The history of the statute and its construction from an early date fully substantiate these conclusions. A deduction for certain losses "actually sustained" during the taxable year was provided for individual taxpayers in Section II B, and for corporate taxpayers in Section II G (b) of the Income Tax Act of 1913, c. 16, 38 Stat. 114.[3] This provision was expanded in Section 5 (a), Fourth, of the Revenue Act of 1916, c. 463, 39 Stat. 756, to include, for individual taxpayers, a specific reference to losses from "theft"—and such losses have continued to constitute grounds for deduction in all subsequent income tax enactments. As early as 1919, in O-845, 1 Cum. Bull. 118, it was ruled that embezzlement losses were "sustained" and deductible in the years when they occurred and not in the later year of discovery. The ruling relied on an unreported decision in *United States* v. *Cleveland, Cincinnati, Chicago & St. Louis Railway Co.*, decided on February 23, 1916 (S.D. Ohio),[4] where embezzlements taking place during several prior years were discovered in 1909 and

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[3] Provisions for loss deductions and the requirement that they be taken in the year when the loss was sustained can be traced to Section 13, Act of March 2, 1867, c. 169, 14 Stat. 471. A similar deduction for certain losses "sustained" during the year appears in Section 28, Act of August 27, 1894, c. 349, 28 Stat. 509, and in Section 38, Corporation Excise Tax Act of 1909, c. 6, 36 Stat. 11, 112.

[4] That case was also cited and relied on in *Bentley* v. *Commissioner*, 5 B.T.A. 314, 323; *Peterson Linotyping Co.* v. *Commissioner*, 10 B.T.A. 542, 544.

where the taxpayer claimed a deduction under the Corporation Excise Tax Act of 1909, c. 6, 36 Stat. 11, 112-118, which also granted deductions for losses actually sustained within the taxable year. The court is said to have disallowed the deduction and to have stated (p. 119):

> The time of the discovery of a loss bears no relation to the date the loss was sustained. The loss was sustained when the theft occurred, although the defendant did not know at the time of the depletion of its assets. As each embezzlement occurred, the defendant was poorer to the extent of it. It then sustained a loss. One of the definitions of "sustained" is "undergo." As each embezzlement occurred, the defendant underwent the loss of that much money. It is clear that the defendant is not entitled to the deduction claimed.

Similarly, in I. T. 1470, I-2 Cum. Bull. 60 (1922), it was ruled that the loss "is allowable as a deduction from gross income for the year or years in which the funds were so converted * * *." See also A.R.R. 2503, II-2 Cum. Bull. 131 (1923). This interpretation was noted by this Court in *Burnett* v. *Huff*, 288 U. S. 156, 159, where it was said:

> The Government concedes that if assets of the taxpayer used in trade or business, or "in

> any transaction entered into for profit," are stolen in any year, the taxpayer sustains the loss in that year and the deduction must then be taken even though the theft is not discovered or the amount ascertained until the following year. * * *

The decided cases, with complete uniformity until 1942, have ruled that an embezzlement loss is "sustained" and is deductible only in the year when the embezzlement occurs, regardless of when the loss is discovered. *First Nat. Bank of Skaron, Pa.* v. *Heiner*, 66 F. 2d 925 (C.A. 3d); *Montgomery* v. *United States* (N.D. Ala.), decided September 27, 1932 (15 A.F.T.R. 865); *Rahr Malting Co.* v. *United States*, 54 F. Supp. 282 (E.D. Wisc.), affirmed on other points, 145 F. 2d 867 (C.A. 7th); *Bentley* v. *Commissioner*, 5 B.T.A. 314; *National Sash & Door Co.* v. *Commissioner*, 5 B.T.A. 931; *Peterson Linotyping Co.* v. *Commissioner*, 10 B.T.A. 542; *Gottlieb Realty Co.* v. *Commissioner*, 28 B.T.A. 418; *Piggly Wiggly Corp.* v. *Commissioner*, 28 B.T.A. 412; *Alabama Mineral Land Co.* v. *Commissioner*, 28 B.T.A. 586; *Grenada Bank* v. *Commissioner*, 32 B.T.A. 1290; *Burke Grain Co.* v. *Commissioner*, 39 B.T.A. 334; *Miglietta* v. *Commissioner*, decided January 28, 1943 (1943 P-H T.C. Memorandum Decisions, par. 43,045). Accord: *Borden* v. *Commissioner*, 101 F. 2d 44 (C.A. 2d), and *Simons* v. *Commissioner*, 1 B.T.A.

351 (losses from thefts deductible in years of theft and not in later years when first discovered). See *Piedmont Grocery Co.* v. *United States,* 66 C. Cls. 468, certiorari denied, 280 U. S. 554.

*First Nat. Bank of Sharon, Pa.* v. *Heiner* and *Montgomery* v. *United States, supra,* like the *Alison* case under review, involved situations where embezzlements were discovered after the statute of limitations had run so that it was too late to permit the deduction to be claimed by the filing of amended returns for the year of the loss. It was held, nonetheless, that the loss could not be deducted in the year when discovered.

The contrary result was reached in *Boston Consol. Gas Co.* v. *Commissioner,* 128 F. 2d 473 (C.A. 1st), although the court there recognized that Section 23 required the loss to be deducted in the year of the embezzlement. This case is discussed under Point B, pp. 18-21, and under Point C, pp. 32, 37-38, *infra,* as the majority of the court based its decision upon the supposed exception under Code Section 43 and the Treasury Regulations issued thereunder.

So far as Section 23 is concerned, we deem it undeniable that that section requires an embezzlement loss to be deducted in the year of the embezzlement and precludes the deduction from being allowed in any other taxable period. The clear language of that section which, from the very beginning, has always specified that the loss be taken in the year when sustained, and which has been

fortified by a long history of administrative construction and judicial decisions on this point, can leave no room for serious dispute of this proposition.[5] Accordingly, if, under exceptional circumstances, the loss deduction can be taken in some other year, such as the year of discovery, and if the present cases represent such an exception, the authority to allow the deduction must be found somewhere other than in Section 23.

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[5] In his concurring opinion in *Boston Consol. Gas Co.* v. *Commissioner*, 128 F. 2d 473, 476-477 (C. A. 1st), Judge Magruder, influenced by the lack of taxable gain to the embezzler, attempted to justify the result of the decision there on the ground that an embezzlement loss was peculiar and was "sustained" within the meaning of Section 23(f), not when the embezzlement took place, but rather when the victim ascertained that he could not obtain complete reimbursement from the wrongdoer.

While this reasoning is fundamentally faulty, the short and conclusive answer is that Section 23(e) and (f) has always been interpreted to mean that an embezzlement loss is "sustained" when the embezzlement takes place. The repeated reenactment of the statute demonstrates that Congress intended that the word "sustained" be so interpreted. Further, if Judge Magruder's reasoning were followed, it would result in the conclusion that no embezzlement loss is deductible in the year when the embezzlement occurs unless, coincidentally, the victim ascertains at that time that he cannot be made whole. This, of course, would be contrary to the consistent course of interpretations and decisions.

The subsequent decision of this Court in *Commissioner* v. *Wilcox*, 327 U. S. 404, also demonstrates why the lack of taxable gain to the embezzler has no bearing on the time of the deduction, for it was there pointed out (p. 409) that there is no "necessarily corresponding relationship" between the taxable gains of the embezzler and the deductions afforded by Congress to the victim.

**B. Code Section 43 Does Not Permit an Embezzlement Loss Deduction to be Shifted From the Year When the Loss is Sustained to the Year When Discovered. It is Not Material That the Deduction for the Loss Years is Barred by Limitations, Nor is it Material That the Loss Years are Unascertainable.**

The only judicial decision (other than the decision on review in the *Stevenson-Chislett* case) which purports to find authority for an exceptional treatment of embezzlement losses is *Boston Consol. Gas Co.* v. *Commissioner,* 128 F. 2d 473 (C.A. 1st).[6] That decision, however, is erroneous and cannot be accepted as a valid precedent.

In that case the taxpayer, on the death of its treasurer in 1935, discovered a large cash shortage which appeared to have been due to prior embezzlements. In the annual audit made in 1934 for the preceding year, no such cash shortage had been disclosed. After adjustments had been made for amounts recovered from a bonding company and from the deceased treasurer's "beneficiaries," the taxpayer deducted the net loss in its 1935 return. The Board of Tax Appeals, following a previous line of authority from which there had been no deviation, held with the Commissioner that only the net amount actually embezzled in 1935 was deductible in that year. 44 B.T.A. 793. The Court of Appeals, however, reversed. The statutory requirement that the loss be deducted in the year when sustained, the Court said, was to prevent a

[6] The Tax Court attempted to follow this decision as part of its rationale in *Gwinn Bros. & Co.* v. *Commissioner,* 7 T. C. 320 (acquiescence in result only, 1946-2 Cum. Bull. 2).

taxpayer from making his own selection of the year in which the deduction would be claimed. But it said (p. 476)—

> we believe that Congress did not intend that its rule should be inelastically and rigidly applied, and this we think the Treasury Department recognized when it used the word "ordinarily" in the last sentence of Article 43-2 of its Regulations 86.

The court observed that usually where the embezzlement was discovered in a later year, an amended return could be filed for the year of the loss. However, because it was thought that the taxpayer in that case (p. 476) was "unable to determine the actual dates of the different acts of embezzlement,"[7] the Court concluded that the (*ibid.*) "situation is so extraordinary that its total net loss may be deducted in the year when the loss was discovered and its extent determined * * *."

The Court of Appeals, it should be noted, did not rule that the loss was "sustained" in 1935 or deny that it was "sustained" in the years when the embezzlements took place, within the meaning of

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[7] The record in the *Boston Consol. Gas Co.* case does not justify this factual conclusion by the Court of Appeals. Aside from the inferences to be drawn from the agreed fact that the 1934 audit did not disclose the cash shortage, there is nothing in the stipulated facts, on the basis of which the case was tried, to the effect that the taxpayer was unable or would find it difficult to determine the exact years of the embezzlement.

Section 23(f) of the Revenue Act of 1934, c. 277, 48 Stat. 680. Nor did the court purport to find in Section 23(f) any exception for extraordinary situations. Instead, the decision is clear in holding that authority for an exception was to be found in the Treasury Regulations construing Section 43 of the 1934 Act. The court's conclusion that the circumstances of that case fell within a supposed exception was its own, and is unsupported by any precedent.[8] As will be seen, Section 43 (Appendix A, *infra*, p. 55) and the cognate Treasury Regulations do not sanction such a deviation regarding the time when embezzlement losses are to be deducted.

Code Section 43 provides that deductions and credits shall be taken in the taxable year in which "paid or accrued" or "paid or incurred" in accordance with the taxpayer's method of accounting "unless in order to clearly reflect the income the deductions or credits should be taken as of a different period." This language, however, does not create an exception of the kind applied in the *Boston Consol. Gas Co.* case and which the tax-

[8] *Glenn* v. *Louisville Trust Co.*, 124 F. 2d 418 (C. A. 6th), which the court recognized as not being squarely in point, but which it relied on as indicating the proper view of the statute, held that a loss resulting from the compromise of a disputed claim against a fiduciary for an unauthorized, improper investment was sustained and deductible in the year when the claim was settled. It had nothing to do with an undisputed embezzlement loss or the year in which such a loss would be sustained.

payers seek to invoke in the circumstances of the present cases. Thus, in *Security Mills Co.* v. *Commissioner*, 321 U. S. 281, the taxpayer similarly attempted to invoke the "unless" clause of Section 43 as an exception to the annual accounting rule in circumstances where it was claimed that it would be "unjust or unfair" not to do so. This Court, after examining the history of Section 43, rejected the contention that it granted discretionary authority to prevent unjust results. The opinion, speaking of Section 43, stated (pp. 285-286)—

> it is clear that the purpose of inserting the qualifying clause was to take care of fixed liabilities payable in fixed installments over a series of years. * * * But we think it was not intended to upset the well-understood and consistently applied doctrine that cash receipts or matured accounts due on the one hand, and cash payments or accrued definite obligations on the other, should not be taken out of the annual accounting system and, for the benefit of the Government or the taxpayer, treated on a basis which is neither a cash basis nor an accrual basis, because so to do would, in a given instance, work a supposedly more equitable result to the Government or to the taxpayer.

The history of Section 43 fully confirms the correctness of the ruling in the *Security Mills Co.* case and demonstrates that that section does not confer upon taxpayers the right to claim a loss deduction in a year when no loss was in fact sustained. The "unless" clause had its origin in Sections 214(a)(6) and 234(a)(4) of the Revenue Act of 1921, c. 136, 42 Stat. 227, which, as was true of prior enactments, provided that all losses (not merely those arising from theft) should be deducted in the year in which sustained, and which added—"unless, in order to clearly reflect the income, the loss should, in the opinion of the Commissioner, be accounted for as of a different period" In explanation of this, the Senate Committee on Finance stated (S. Rep. No. 275, 67th Cong., 1st Sess., pp. 14-15 (1939-1 Cum. Bull. (Part 2) 181, 191)—

> losses occurring in one year are frequently not determined or sustained until another year, depending upon court decision or the clearing up of uncertainty. To permit more elastic treatment of such losses, in the interests of justice to the taxpayer, it is provided that certain losses shall not be deducted as of the taxable year in which sustained, if in the opinion of the commissioner they should be accounted for as of a different period; * * *

Since the committee was concerned with the tax treatment of losses when there was some uncertainty concerning the rights of the taxpayer which became clarified in a subsequent year, and since the standard on which the Commissioner was to act in exercising his discretion to require a clear reflection of income was somewhat vague, at least as it was stated by the committee, it was evidently difficult to carry out the embryonic policy embodied in these sections. The Commissioner did his best to comply. Thus, in Treasury Regulations 62, promulgated under the 1921 Act, Article 111 provided that—"A loss from theft or embezzlement occurring in one year and discovered in another is ordinarily deductible for the year in which sustained." The prior Regulations had provided that the loss was deductible "only" for the year in which sustained.[9] Article 146 of Treasury Regulations 62, to which Article 111 made a cross-reference, stated the general rule to be that losses were to be deducted in the year when sustained. Calling attention to the Commissioner's authority to permit the deduction to be taken in another year in order to avoid injustice to the taxpayer and to reflect income more clearly, Article 146 continued by saying "For example, an embezzlement or a shipwreck may occur in 1921 but not become known until 1922 and in such a

[9] Art. 111, Treasury Regulations 45, promulgated under the Revenue Act of 1918.

case income may be more clearly reflected by accounting for the loss as of 1922 rather than 1921." If a taxpayer desired to account for a loss as of a different period than the year in which sustained, the Regulations required a complete statement of the facts, but provided that in his tax return "he shall deduct the loss only for the taxable year in which actually sustained;" the Commissioner, upon the basis of the taxpayer's statement, would decide whether the circumstances fell within the exception of the statute, and if not, the loss would be allowed only for the taxable year in which sustained. It was made clear, moreover, that "The allowance of a deduction for a loss in a year other than the one in which sustained is entirely within the discretion of the Commissioner and he will consider exercising this descretion only in exceptional cases."

We may pause at the 1921 Act to observe that, vague as were the standards for the exercise of the Commissioner's discretion, there was no evident notion that a loss should be deductible during a different year merely because it was discovered after the statute of limitations prevented a deduction for the year of the occurrence of the loss. The committee report illustrated situations where uncertainties were cleared up during subsequent years, and did not deal with any mitigation of the statute of limitations or with an inability to ascertain the year of the loss. And,

while the Regulations did not specify the circumstances in which the Commissioner would exercise his discretion to achieve a clear reflection of income, there was no intimation that a distortion of income requiring correction would result from the running of the statute of limitations or from a practical inability to determine the year of the loss, for the example given in the Regulations was one where the year of the loss was known and where the discovery was made in the year immediately after the loss was sustained.

We have been unable to discover any situation in which the Commissioner exercised his discretion under the 1921 Act to permit an embezzlement loss to be deducted in a year other than that in which the embezzlement took place In *Simons* v. *Commissioner*, 1 B.T.A. 351, a theft occurring in 1921 was not discovered until 1922. The Board, referring to these provisions of the 1921 Act, approved the Commissioner's determination that income was clearly reflected by requiring the deduction to be taken in 1921. The decision demonstrates, at the least, that, notwithstanding the illustration in the example of the Regulations, the Commissioner was not exercising his discretion to shift the year of the deduction merely because the loss was discovered in a subsequent year.

The statutory pattern was again altered by the Revenue Act of 1924, c. 234, 43 Stat. 253. Under Sections 214(a)(4), (5), and (6) and 234(a)(4),

as was true prior to the 1921 Act, losses were to be deducted in the year when "sustained," without any qualification being stated in those sections. This has been the statutory rule set forth in every subsequent enactment.[10] The 1924 Act added, as a new provision, Section 200(d), the predecessor of Code Section 43, which provided that deductions should be taken in the taxable year in which "paid or accrued" or "paid or incurred," dependent on the method of accounting employed by the taxpayer, "unless in order to clearly reflect the income the deductions or credits should be taken as of a different period." The quoted language has appeared in all subsequent statutes.[11]

The committee explanation of this exception demonstrates a more mature appreciation of what is involved in the concept of a clear reflection of income and shows, as was held in the *Security Mills* case (321 U. S. 281), that it was not intended that deductions should be taken in other years to avoid what a particular taxpayer regards as an unjust or burdensome consequence of the annual

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[10] Sections 214(a)(4), (5), and (6), and 234(a)(4), Revenue Act of 1926 (c. 27, 44 Stat. 9); Section 23(e) and (f), Revenue Acts of 1928 (c. 852, 45 Stat. 791), 1932 (c. 209, 47 Stat. 169), 1934 (c. 277, 48 Stat. 680), 1936 (c. 690, 49 Stat. 1648), 1938 (c. 289, 52 Stat. 447), and of the Internal Revenue Code.

[11] Section 200(d), Revenue Act of 1926; Section 43 of the Revenue Acts of 1928, 1932, 1934, 1936, 1938, and of the Internal Revenue Code.

accounting system. The Committee on Ways and Means (H. Rep. No. 179, 68th Cong., 1st Sess., pp. 10-11 (1939-1 Cum. Bull. (Part 2) 241, 249)), explaining Section 200(d), stated:

> (2) In subdivision (d) of this section authority is granted to the Commissioner to allow or require deductions and credits to be taken as of a year other than that in which "paid" or "accrued" when, in his opinion, it is necessary in order to clearly reflect the income. The Revenue Act of 1921 in sections 214(a)(6) and 234(a)(4) authorizes the Commissioner to allow the deduction of losses in a year other than that in which sustained when, in his opinion, it is necessary to clearly reflect the income. The proposed bill extends that theory to all deductions and credits. The necessity for such a provision arises in cases in which a taxpayer pays in one year interest or rental payments or other items for a period of years. If he is forced to deduct the amount in the year in which paid, it may result in a distortion of his income which will cause him to pay either more or less taxes than he properly should.

The same explanation is given in S. Rep. No. 398, 68th Cong., 1st Sess., pp. 10-11 (1939-1 Cum. Bull. (Part 2) 266/273).

The purpose to be served by the "unless" clause of Section 43 and its predecessors is "to clearly reflect the income" of the taxpayer. As the *Security Mills* case makes plain, it is the income of the taxable year, measured in relationship to the statutory principle of an annual accounting, which is to be reflected clearly. Such a goal, far from being achieved, would be subverted if, for example, the taxpayer in *Alison* were permitted to deduct in one year the total amount of the net losses which were sustained during a period of nine previous years. Since there was no embezzlement loss in 1941, and since nothing else occurred in that year which would affect the amount of net income earned in 1941, it is difficult to comprehend how there can be a clear reflection of 1941 income if the taxpayer is permitted to take the entire amount, or even any part of the prior years' losses as a deduction in the year 1941. To permit the losses of other years to be deducted in that year not only disturbs the annual accounting system (cf. *United States* v. *Lewis*, 340 U. S. 590, 592; *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, 363), with which Section 43 does not interfere (*Security Mills Co.* v. *Commissioner, supra*, pp. 286-287), but the accumulation of nine years' losses as a single deduction in a single tax year can only result in a distortion of the taxpayer's 1941 income, contrary to the very purpose of Sec-

tion 43.[12] The same observations are equally true of the *Stevenson-Chislett* case.

Section 43 is given its proper scope when applied in the general kind of circumstances described in the Committee Reports and in the *Security Mills* case, *supra*, where the Court said (p. 285):

> For example, a tenant would not be compelled to accrue, in the first year of a lease, the rental liability covering the entire term nor would he be permitted, if he saw fit to pay all the rent in advance, to deduct the whole payment as an expense of the current year.

There are other situations, too, where items which are paid or accrued in one year actually represent the expenses of other years. In all these circumstances the usual accounting method of a taxpayer, when strictly followed, might result in distortions of income, and the shifting of the deduction to other years is necessary to achieve a clear reflection of income. As we have seen, no such situation is presented by either of these cases.

Further, it is to be doubted whether Code Section 43 has any application to deductions for losses, whether due to embezzlement or other causes. It states the general rule to be that deductions and credits should be taken in the year

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[12] The clear reflection of income is the objective not only of Section 43 but also of the other accounting sections. See Code Sections 41 and 45.

when "paid or accrued" or "paid or incurred," and Code Section 48(c) defines those terms in relation to the method of accounting employed by a taxpayer, i.e., cash or accrual. There are numerous allowances where the year of deductibility depends on the taxpayer's method of accounting, for the statute permits them to be taken when "paid" or "incurred" or "accrued." See Section 23(a)(1) and (2), (b), (c)(1), (cc), and (ff). Both the rule of Section 43 and the exception of the "unless" clause are geared to deductions of this kind.

Congress, however, has granted other deductions by specifying when they are to be taken, and as to these the taxpayer's method of accounting is not determinative. For example, Section 23(o), in the case of an individual, and Section 23(q), in the case of a corporation, specifies that a charitable deduction should be taken in the year of payment.[13] Again, under Section 23(k) the general rule is that bad debts are deductible in the taxable year when they become worthless.[14] With respect to those deductions, and others, Congress has required that they be taken in a particular year and

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[13] In the case of a corporation on the accrual basis, the last paragraph of Section 23(q) permits, at the taxpayer's election, the deduction to be taken in the year when the contribution was authorized if it is paid by the 15th day of the third month following the close of the taxable year.

[14] In the discretion of the Commissioner, a taxpayer may deduct a reasonable addition to a reserve for bad debts.

has, in effect, provided a rule for the proper reflection of income having equal application to all methods of accounting. The point is that Section 43, as it states the general rule which permits the taxpayer's accounting system to determine the time when some items are deductible and states the exception which, with respect to the same items, may require a deviation from the usual accounting system when necessary for a clear reflection of income, does not have any application in those instances where the statute itself designates the exact year of the deduction.

These observations are equally applicable to the deduction of embezzlement losses under Section 23(e) and (f). Congress there, too, has required that the deduction be taken in a particular year, namely, the year in which the loss is "sustained." This, as we have shown (pp. 11-17 *supra*), means the year in which the embezzlement occurred. The year in which such a loss is sustained, quite obviously, is not affected by the accounting method employed by a particular taxpayer, for the loss is "sustained" at precisely the same point of time no matter whether the cash or the accrual system is being employed. Or, to use the statutory language, the year in which an embezzlement loss is "sustained" has nothing to do with when an item is "paid or accrued" or "paid or incurred" under Section 43. That section, accordingly, does not purport to state a rule or an exception to a

rule which impinges on Section 23(e) and (f), and it provides no authority for altering the year in which Congress requires that an embezzlement loss be deducted.

**C. The Treasury Regulations Do Not Interpret Code Section 43 As a Buffer Against the Statute of Limitations or Against Other Supposed Hardships.**

As we have already noted, the decision in *Boston Consol. Gas Co.* v. *Commissioner*, 128 F. 2d 473 (C. A. 1st), permitting the embezzlement loss to be deducted in the year when the loss was discovered rested on the notion that such an exception was contemplated by the governing Treasury Regulations which interpret Section 43. Referring to Article 43-2, Treasury Regulations 86, which provided that "A loss from theft or embezzlement occurring in one year and discovered in another is ordinarily deductible for the year in which sustained," and emphasizing the word "ordinarily," the Court concluded that Congress did not intend that an embezzlement loss should always be deducted in the year when sustained, and held that that case fell within the supposed exception. And the taxpayers in the present cases also contend that their situations fall within the indefinite boundaries of such an exception.

We believe, on the contrary, that the word "ordinarily" in the Treasury Regulations was never intended to serve as a vehicle for circumventing the most elemental principles on which

Congress has constructed the pattern of the income tax statute. Violation of the rule requiring an annual accounting, distortion of a taxpayer's income by permitting the losses of other years to be deducted in a single, non-loss year, disregard of the applicable statute of limitations, and the use of equitable principles to avoid hardships—all this the taxpayers contend was sanctioned by the single word "ordinarily" in the Treasury Regulations. Ironically, the Treasury Regulations are supposed to have accomplished this in the interpretation of Section 43 where Congress acted to insure a clear reflection of income and an adherence to the basic annual accounting system. And the Treasury Regulations are supposed to have placed only embezzlement losses in this peculiarly preferred position.

Actually, the word "ordinarily" cannot be considered to carry such an onerous burden of meaning. The statement that an embezzlement loss is "ordinarily" deductible in the year when sustained first appeared in Article 111, Treasury Regulations 62, which, together with Article 146, attempted to give effect to the vague Congressional policy embodied in Sections 214(a)(6) and 234(a)(4) of the 1921 Act which gave the Commissioner discretionary authority to permit a loss deduction to be taken in a year other than the year in which sustained when that would result in a clear reflection of income. (See pp. 23-25, *supra*.)

When the 1924 Act first adopted Section 200(d), from which Code Section 43 is derived, Article 1523, Treasury Regulations 65, promulgated under that Act, recognized the changed situation not only by the totally different language employed, as compared with Article 146 of Treasury Regulations 62, but by deleting any reference to the example given in Article 146 of Regulations 62 to the effect that an embezzlement may occur in 1921 but not become known until 1922, and that income may be more clearly reflected by accounting for the loss in 1922. Article 112, Treasury Regulations 65, as is true of all corresponding provisions of succeeding Regulations,[15] continued, however, to repeat the sentence in Article 111, Treasury Regulations 62, to the effect that an embezzlement loss is "ordinarily" deductible in the year when sustained.

It cannot be doubted that the Regulations would have been more accurate in reflecting the meaning of the statute if the word "ordinarily" had been deleted after the 1924 Act was adopted. The retention of the word "ordinarily" was apparently

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[15] Article 112, Treasury Regulations 69, promulgated under the Revenue Act of 1926; Article 342, Treasury Regulations 74-75, and 77, promulgated under the Revenue Acts of 1928, and 1932; Article 43-2, Treasury Regulations 86, 94, and 101, promulgated under the Revenue Acts of 1934, 1936, and 1938; Section 19.43-2, Treasury Regulations 103, and Section 29.43-2 Treasury Regulations 111, promulgated under the Internal Revenue Code (Appendix A, *infra*).

an oversight on the part of the original draftsmen, continued in subsequent promulgations more by inertia than by a studied purpose. It represents no more than a vestigial appendix, possessing no purposeful meaning since 1924. More significant than this single, isolated word is the fact that the Regulations as a whole do not support the notion that such an extraordinary treatment of embezzlement losses was intended. This, we submit, is evident from the content of the Regulations adopted under the 1924 Act, and continued in subsequent Regulations. Thus, Article 112 of Regulations 65, in which the "ordinarily" phrase is found, stated:

> The expenses, liabilities, or deficit of one year can not be used to reduce the income of a subsequent year. * * * A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he can not deduct them from the income of the next or any succeeding year. * * *"

The same paragraph also stated that—

> If subsequently to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he may render an amended return for such pre-

> ceding taxable year including such amount of loss in the deductions from gross income and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return. See Section 281. * * *[16]

The same language will be found in Section 29.43-2, Treasury Regulations 111, promulgated under the Internal Revenue Code (Appendix A, *infra*, p. 58). There could be no plainer statement of the rule that all deductions must be taken in the proper year, even when the right to the allowance is discovered later. And nowhere in the Regulations is there the slightest indication that there is to be a deviation simply because the rule may be thought to be harsh or oppressive in particular circumstances. Indeed, by requiring that amended returns be filed for the proper year if they are not barred by limitations, the Regulations would seem to preclude the conclusion that the deduction may be taken in the improper year after limitations has run. At least, if there had been any intention to permit the deduction to be taken in the wrong year when the right to the deduction is discovered too late, it would be expected

[16] Section 281 of the 1924 Act, here referred to, contains the authority for refunds and sets forth the period of limitations beyond which such refunds cannot be paid.

that the Regulations would have stated such an important exception in clearer language than the word "ordinarily."

Further, and also more significant than this vague, unexplained word in the Regulations, is the fact that those who are charged with the administration of the law have not interpreted the Regulations to require the results contended for by these taxpayers. We have been unable to discover any published ruling, interpretation, or instruction in which the Commissioner has construed the Regulations to possess such a meaning. And the informal practice by which particular cases of this kind are being handled by individual field offices of the Bureau of Internal Revenue demonstrates that the Regulations are not regarded as requiring the allowance of the deduction in the discovery year. The general practice of these offices appears to be in harmony with what we consider to be the correct application of the statute and the Regulations. While there have been some situations where individual cases, sometimes for settlement purposes, have been disposed of differently, they are in the distinct minority. This informal practice is described in greater detail in a letter from the Commissioner of Internal Revenue dated October 1, 1952, set forth in Appendix B, *infra*.

The court in the *Boston Consol. Gas Co.* case

rested its conclusion on a single word of the Regulations. If, instead, it had examined the history of the statute and the Regulations; if it had appreciated that the Commissioner had not interpreted the Regulations in that manner, and if it had had the benefit of this Court's subsequent decision in *Security Mills Co.* v. *Commissioner*, 321 U. S. 281, respecting the meaning of Section 43, and of the subsequent decision in *Boehm* v. *Commissioner*, 326 U. S. 287, relating to the time for the deduction of losses under Section 23, we believe it would have reached the opposite result.

Finally, even if the word "ordinarily" should be deemed to imply that the Commissioner will permit exceptional treatment in extraordinary situations, it does not follow that the present cases fall within the exception, whatever its boundaries may be. The Commissioner, by refusing to allow the claims for refund in these cases, evidently believed that the income of the taxable years would not be reflected more clearly by permitting the deduction to be taken in these years. Since the ultimate key to the resolution of this conflict must be found in the statute, and since Code Section 43 is concerned only with a clear reflection of a taxpayer's income, the present taxpayers can establish that the Commissioner's action was erroneous only if they demonstrate that their income for the taxable years will be clearly reflected by claiming a deduction at that time for

losses of other years. This, we believe, they cannot successfully do. (See pp. 28-29, *supra*.)[17]

**D. If the Year When Embezzlement Losses Are Deductible is to be Shifted to Prevent Hardships, the Matter is One For Congressional Action.**

1. The ultimate circumstances on which the taxpayer in *Alison* bases her right to claim the entire deduction in 1941 for embezzlement losses sustained during the years 1931-1940, inclusive, is

[17] Furthermore, Section 29.43-1 of Regulations 111, in dealing with the exception of Section 43 designed to produce a clear reflection of income, makes it plain that a taxpayer cannot lightly assume that the exception applies, for even when a taxpayer believes that income will be clearly reflected by claiming a deduction in a year other than that in which the item was paid or incurred, the Regulations require that the deduction be claimed in the year when paid or incurred, and the taxpayer must submit all the facts to the Commissioner who will advise the taxpayer whether the situation falls within the exception and of the proper year in which the credit is to be taken.

This requirement of the Regulations, which has been in existence for nearly 30 years, is a reasonable and valid one; a taxpayer who fails to comply with its terms is, for that reason alone, not entitled to rely on the exception stated in Section 43 to claim a deduction for a different period than the year in which the item is paid or accrued. *Cassatt* v. *Commissioner*, 137 F. 2d 745, 749 (C. A. 3d).

In the present cases, accordingly, even if the exception of Section 43 could be deemed to have any application to loss deductions from embezzlement, the failure of the taxpayers to follow this requirement of the Regulations, namely, the submission of all facts to the Commissioner to permit him to determine whether the deduction should be taken in a different year, should result in a denial of the deduction in a year other than those in which the losses were sustained.

that the deduction was barred by limitations when the embezzlements were first discovered, so that adherence to the rule that the losses are deductible in the year when sustained would operate to deprive her of the deduction altogether. This argument, we note, could have no application to the losses sustained in 1938 through 1940, for those years were not barred when the losses were discovered in 1941, and the taxpayer could have filed amended returns and a claim for refund with respect to those years, as is required by Section 29.43-2, Treasury Regulations 111 (Appendix A, *infra*, pp. 57-58).

The basic argument, however, assumes not only that the statute permits the year of the deduction to be shifted in extraordinary circumstances, but also that the running of the statute of limitations imposes a hardship which should be alleviated. We have demonstrated that the first assumption is erroneous. We believe, moreover, that the second assumption is ill-founded.

Inequities and hardships which may arise from the running of the statute of limitations, and which affect the Government as well as taxpayers, do not pose problems with which the legislature is unfamiliar. Code Section 3801 represents the extent to which Congress, in a very limited area, has seen fit to provide some measure of mitigation against the effects of the statute of limitations. See Maguire, Surrey, and Traynor, *Section 820 of*

*the Revenue Act of 1938*, 48 Yale L.J. 509, 719 (1938-1939), for a description of the history and operative scope of the predecessor of Code Section 3801.[18]

Several significant conclusions are evident from the enactment of Code Section 3801. That section is designed to prevent the deduction of the same item or the taxing of the same income more than once, for it is to be applied only where the taxpayer or the Commissioner has taken a position in one year which is inconsistent with that taken

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[18] Section 820 of the Revenue Act of 1938, the predecessor of Code Section 3801, resulted from one of the recommendations made by the Subcommittee of the House Ways and Means Committee, 75th Cong., 3d Sess., on "A Proposed Revision of the Revenue Laws." Its ultimate recommendation was couched in broad terms (p. 79, Recommendation No. 48) —"that there be prepared suitable provisions under which the statute of limitations should be so adjusted as to insure the taxation of income, and the allowance of deductions, in the year to which properly allocable." The specific consideration of this matter by the Subcommittee (pp. 54-55) reveals that the problem to be remedied encompassed a more narrow area than that stated by the general language of the ultimate recommendation. In addition, the statute, as enacted, did not parallel the Subcommittees' recommendations in all respects. See Maguire, Surrey, and Traynor, *Section 820 of the Revenue Act of 1938*, 48 Yale L. J. 509 (1938-1939).

Similar recommendations along the same general lines had been made in 1933 in House Committee Print, Prevention of Tax Avoidance, Preliminary Report of a Subcommittee of the Committee on Ways and Means, 73d Cong., 2d Sess., p. 12. See Tyler and Ohl, *The Revenue Act of 1934*, 83 U. of Pa. L. Rev. 607, 644 (1934-1935).

with respect to the same item in a prior year which would otherwise be barred. The purpose of Section 3801 to open up a barred year only to avoid an inconsistent position by a taxpayer or the Commissioner demonstrates that Congress did not intend that limitations should be disregarded in other situations. Thus, the mere fact that the statute of limitations has run so as to prevent a deduction from being claimed in the proper year, as is true of some of the years in the *Alison* case, is not a sufficient reason to depart from the legislative policy which is inherent in a statute of repose. The fact that Congress enacted Section 3801 also emphasizes the conclusion (Point B, pp. 18-32, *supra*), that Section 43 did not and was not intended to serve as a vehicle for shifting deductions from one year to another for the purpose of avoiding the statute of limitations whenever the courts or the Commissioner believed that it would be "equitable" to do so.

Section 3801 (d), moreover, within its narrow sphere of operation, is designed to determine the tax of the barred year in the same manner as it would have been calculated if the item of deduction had been taken or the item of income had been included in the proper year. Thus, the legislative solution, within this area, is to achieve a correct computation of the tax for the correct year. It does not disturb the basic annual accounting system. This is to be contrasted with the result

contended for by the taxpayer, Alison, under which, without any statutory authorization, she seeks to avoid the statute of limitations by claiming the deductions of barred years in a year which would ordinarily be conceded to be the wrong one, and she would further distort her true income of that year by aggregating in one taxable period the total losses accumulated during nine previous years.

Equally significant as it bears on the problem of the *Alison* case is the amendment made by Section 169 of the Revenue Act of 1942, c. 619, 56 Stat. 798, to Code Section 322 (b)(2). That section created a special period of limitations (seven years) in which refund claims could be filed to claim a deduction on account of losses from worthless debts or securities. Congress created this exceptional period of limitations because taxpayers frequently ascertained the proper year of the deduction only after the normal three year period of limitations had run; it was thought that it would be more equitable to give such taxpayers a longer period within which the deduction could be claimed for the proper year. H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 44-45, 78, 120 (1942-2 Cum. Bull. 372, 408, 432, 461); S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 156-157 (1942-2 Cum. Bull. 504, 620).

The legislative action creating a longer period of limitations within which these specific losses

could be claimed as deductions is another illustration why no similar exception can be created for embezzlement loss short of Congressional amendment of the statute. Further, while Congress extended the statute, there is still a definite limitation of seven years within which loss from worthless debts and securities must be claimed. The taxpayer, Alison, however, would apparently contend that the embezzlement loss can be claimed in the discovery year no matter how many years have elapsed since the embezzlement took place. Moreover, even when discovered within seven years, a loss from a worthless debt or security must still be claimed as of the proper year when the loss was actually sustained, while the taxpayer, Alison, asserts the right to deduct her losses in a year when no loss was sustained.

The disadvantages which this particular taxpayer may experience by being deprived of the loss deduction for some of the earlier years in which the losses were sustained do not stand alone in the balance for, as this Court said in *Rothensies* v. *Electric Battery Co.*, 329 U.S. 296, 301, "a statute of limitation is an almost indispensable element of fairness as well as of practical administration of an income tax policy."[19] The same

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[19] In the *Electric Battery* case, *supra*, p. 302, it was also stated: "As statutes of limitations are applied in the field of taxation, the taxpayer sometimes gets advantages and at other times the Government gets them. Both hardships to the taxpayers and losses to the revenues may be pointed out."

thought was voiced by the Court in *Ross* v. *Commissioner*, 169 F. 2d 483, 494 (C.A. 1st), where it was stated that "The statute of limitations itself has equitable aspects * * *."

Whether the supposed inequity to the present taxpayer is one which should outweigh the equitable aspects of the statute of limitations is not a matter requiring resolution by the courts or by the Commissioner, for we are dealing with a taxing statute where Congress is the sole arbiter of what policy considerations should govern. Equally apt here is the statement in *Rothensies* v. *Electric Battery Co., supra*, p. 303, to the effect that "If there are to be exceptions to the statute of limitations, it is for Congress rather than for the courts to create and limit them."

We believe, accordingly, that the question certified by the Court of Appeals was correctly answered by it in *First Nat. Bank of Sharon, Pa.* v. *Heiner*, 66 F. 2d 925, where it was held that an embezzlement loss was not deductible in the year in which discovered even though (p. 926) "Unfortunately, the period had expired during which an amended return could be filed for the year of the embezzlement * * *." Accord: *Montgomery* v. *United States* (N.D. Ala.), decided September 27, 1932 (15 A.F.T.R. 865). Also, the correct rule was stated by Judge L. Hand when, speaking for the court in *Borden* v. *Commissioner*, 101 F. 2d 44 (C.A. 2d), where it was held that a theft loss was

deductible in the year of the theft and not in the year of discovery, he said (p. 45):

> These considerations would indeed dispose of the case, even if the fraud had not been discovered until it was too late to get a refund for 1931 * * *.

2. The ultimate circumstances on which the taxpayer in *Stevenson-Chislett* bases the right to claim the entire deduction in 1945 of embezzlement losses sustained during prior years, and on which the ruling of the District Court rested (R. 5a-11a), is that, as found by the District Court (R. 5a) "it was a practical impossibility to ascertain the exact year or years in which the succession of shortages occurred."[20]

The hardship which may be experienced by a particular taxpayer who finds it difficult to establish the exact year in which a loss deduction should be taken is, again, not a problem with which the legislature is unfamiliar. The requirement of the statute that losses be deducted in the year when sustained was believed to pose a special problem during the last war with respect to property located abroad in areas coming under

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[20] The District Court also found (R. 5a):

> An attempt to segregate the exact year or years in which such shortages occurred would have required a very detailed and extensive audit and investigation with no assurance that such investigation would have disclosed the actual dates of the acts of embezzlement.

he control of the enemy or in which the war was being fought. Congress was requested to alleviate the difficulties which taxpayers would experience in establishing the precise year of loss with respect to such property. See Hearings on Revenue Revision of 1942 before the House Ways and Means Committee, 77th Cong., 2d Sess., pp. 2528-2538. Congress responded by enacting Code Section 127 which, among other things, established the date on which certain property in war areas or in enemy country would be "deemed" to have been destroyed or seized. The fixing of such a date in the statute obviated the necessity of the taxpayer's establishing the precise date of the loss, and was a practical solution to a difficult problem posed by the existing statutory requirement. S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 40-41, 127-130 (1942-2 Cum. Bull. 504, 538-539, 599-601); H. Conference Rep. No. 2586, 77th Cong., 2d Sess., pp. 48-49 (1942-2 Cum. Bull. 701, 710-711).

Another illustration will be found in the deduction of losses from worthless debts and certain worthless securities. Prior to 1942, the statutory requirement had been that the loss should be deducted in the taxable year in which the debt or security was ascertained to be worthless and was charged off. Because this requirement had been a source of considerable difficulty to taxpayers in determining the year of the deduction or in obtaining the deduction at all, Congress, by Section

124(a) of the Revenue Act of 1942, amended Code Section 23 (k) so as to permit the deduction in the year in which the debt or security became worthless, thus making it easier for taxpayers to claim the deduction in the proper year[21] (H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 44, 76 (1942-2 Cum. Bull. 372, 408, 431); S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 89-90 (1942-2 Cum. Bull. 504, 572).)

The enactment of Code Section 127 and the amendment of Code Section 23 (k) merely illustrate the obvious, namely, that a loss deduction under Section 23 (e) and (f) must be taken in the year in which the loss is sustained and that hardship or difficulty in establishing the year of the loss does not afford any basis for claiming the deduction in a different year, except when Congress sees fit to permit an express deviation. This Court has repeatedly pointed out that deductions are a matter of legislative grace and that a taxpayer must come squarely within the statute to be entitled to a claimed deduction. These are not mere empty phrases. They mean that Congress is completely free to decide what deductions may be used in calculating taxable net income and the terms on which such deductions may be claimed. If a taxpayer finds it difficult or even

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[21] As already noted (p. 43 *supra*), Congress also extended the period of limitations within which these losses could be claimed.

impossible to comply with the conditions on which a particular deduction is granted, that does not obviate the necessity of compliance. For example, in *Burnet* v. *Houston,* 283 U. S. 223, the lower court, in disregard of the plain legislative language, had dispensed with proof concerning March 1, 1913, value as a basis for measuring the extent of a deductible loss on the ground that it was a "sheer impossibility" to do so. This Court disagreed, saying (p. 228):

> We cannot agree that the impossibility of establishing a specific fact, made essential by the statute as a prerequisite to the allowance of a loss, justifies a decision for the taxpayer based upon a consideration only of the remaining factors which the statute contemplates. The definite requirement of § 202 (a) (1) of the act is not thus easily to be put aside. The impossibility of proving a material fact upon which the right to relief depends, simply leaves the claimant upon whom the burden rests with an unenforcible claim, a misfortune to be borne by him, as it must be borne in other cases, as the result of a failure of proof. * * *.

As it relates to losses, the Congressional requirement is that the deduction be taken in the year when the loss was sustained. The fact that it may be difficult or even impossible for the

present taxpayer to claim the loss in the proper year does not constitute a basis on which the Commissioner or the courts can permit the deduction to be claimed in a different, erroneous year. The taxpayer's claim to special treatment here is fairly reminiscent of the taxpayer's contentions in *Boehm* v. *Commissioner*, 326 U. S. 287, to the effect that the loss deductions there should be allowed in the year when they were ascertained rather than the year in which they were actually sustained in order to avoid the difficulties confronting a taxpayer who attempts to choose the proper year for the deduction. This Court, after noting that these difficulties were inherent in Section 23(e), stated that (p. 295):

> Any desired remedy for such a situation, of course, lies with Congress rather than with the courts. It is beyond the judicial power to distort facts or to disregard legislative intent in order to provide equitable relief in a particular situation.

The requirement that a loss be deducted in the year when sustained has existed in the present income statutes since 1913. During this long course of time, although it has acted with respect to other losses, Congress has never indicated that there is any particular need of taking special cognizance of difficulties in proving the year of embezzlement losses. If the legislature should become convinced

that this is a problem area which imposes a special hardship on taxpayers, that is a matter for it, not for the courts or the Commissioner, to cure.

One final observation about the *Stevenson-Chislett* case is in order. The trial judge, it should be noted, did not find that it would be impossible for the taxpayer to establish the years and the amounts of the embezzlement, but rather that it was (R. 5a) "a practical impossibility" to do so. His discussion (R. 6a) amplifies this by stating that a "detailed and extensive audit might have thrown some light" but would "have been burdensome" with "little likelihood of success." He concluded that it was "not reasonable to require the taxpayer to expend substantial sums on an extensive audit" which "had little hope of success in fixing the times of the embezzlements * * * ."

The lower court may have been making the erroneous assumption that the taxpayer would not be entitled to any deduction for the years in which the losses were sustained unless it was able to establish the precise amount embezzled in each year. We believe, on the contrary, that in this situation the court might well have applied the rule of *Cohan* v. *Commissioner*, 39 F. 2d 540 (C.A. 2d), which has been followed by the courts in numerous situations. In that case the Board of Tax Appeals had refused to allow any deduction for travelling and entertainment expenses on the ground that there was no proof of the exact

amount spent. The Court of Appeals reversed, stating (pp. 543-544):

> Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent. * * * It is not fatal that the result will inevitably be speculative; many important decisions must be such. We think that the Board was in error as to this and must reconsider the evidence.

In the present case, it might well be that the taxpayer, had it made a reasonable attempt, could have carried its investigation at least to the point where a reliable approximation of the amounts embezzled in prior years would have been possible. Even though the precise amounts remained undiscovered, the lower court, following the *Cohan* rule, would have had some basis for determining what deductions were allowable in the proper years. That the taxpayer did not do so is no justification for allowing the entire losses of earlier years to be deducted in the one year which is assuredly the wrong one since no loss was sustained in that taxable period. Of course, if it was impossible for the taxpayer even to make a re-

liable approximation, then it would not be entitled to any deduction, for there is no legitimate basis for allowing a deduction in 1945. Cf. *Burnet* v. *Houston*, 283 U.S. 223.

## CONCLUSION

The decision of the District Court in *Alison* v. *United States* (No. 79) should be affirmed. The decision of the District Court in *United States* v. *Stevenson-Chislett, Inc.* (No. 80) should be reversed.

Respectfully submitted,

ROBERT L. STERN,
*Acting Solicitor General.*

CHARLES S. LYON,
*Assistant Attorney General.*

ELLIS N. SLACK,
LEE A. JACKSON,
HILBERT P. ZARKY,
*Special Assistants to the Attorney General.*

OCTOBER, 1952.

## APPENDIX A

INTERNAL REVENUE CODE:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(e) *Losses by Individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; or

(3) of property not connected with the trade or business, if the loss arises from fire, storms, shipwreck, or other casualty, or from theft. No loss shall be allowed as a deduction under this paragraph if at the time of the filing of the return such loss has been claimed as a deduction for estate tax purposes in the estate tax return.

(f) *Losses by Corporations.*—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

* * * * *

(26 U.S.C. 1946 ed., Sec. 23.)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period.
* * *

(26 U.S.C. 1946 ed., Sec. 43.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.23(e)-1. *Losses By Individuals.*—Losses sustained by individual citizens or residents of the United States and not compensated for by insurance or otherwise are fully deductible if (*a*) incurred in the taxpayer's trade or business, or (*b*) incurred in any transaction entered into for profit, or (*c*) arising from fires, storms, shipwreck, or other casualty, or theft.
* * *

In general losses for which an amount may be deducted from gross income must be evidenced by closed and completed transactions, fixed by identifiable events, bona fide and actually sustained during the taxable period for which al-

lowed. Substance and not mere form will govern in determining deductible losses. Full consideration must be given to any salvage value and to any insurance or other compensation received in determining the amount of losses actually sustained. * * *

* * * * *

Sec. 29.23(f)-1. *Losses by Corporations.*—Losses sustained by domestic corporations during the taxable year and not compensated for by insurance or otherwise are deductible * * *

Sec. 29.43-1. *"Paid or Incurred" and "Paid or Accrued."*—(*a*) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48 (c).) The deductions and credits provided for in chapter 1 (other than the dividends paid credit provided in section 27) must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued" or "paid or incurred," he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. How-

ever, in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Internal Revenue Code, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

* * * *

Sec. 29.43-2. *When Charges Deductible.*—Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pur-

suant to a consistent policy, takes them into his accounts. Judgments or other binding adjudications, such as decisions of referees and boards of review under workmen's compensation laws, on account of damages for patent infringement, personal injuries, or other cause, are deductible from gross income when the claim is so adjudicated or paid, unless taken under other methods of accounting which clearly reflect the correct deduction, less any amount of such damages as may have been compensated for by insurance or otherwise. If subsequent to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he may render an amended return for such preceding taxable year including such amount of loss in the deductions from gross income and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return. (See section 322.) A loss from theft or embezzlement occurring in one year and discovered in another is ordinarily deductible for the year in which sustained.

Secs. 19.23(e)-1, 19.23(f)-1, 19.43-1 and 2, Treasury Regulations 103, promulgated under the Internal Revenue Code, are the same as those of Secs. 29.23(e)-1, 29.23(f)-1, and 29.43-1 and 2.

APPENDIX B

October 1, 1952

Mr. Charles S. Lyon
Acting Assistant Attorney General
Tax Division
Department of Justice
Washington 25, D. C.

Dear Mr. Lyon:

In connection with the preparation of the Government's briefs to the Supreme Court in the pending cases of *Alison* and *Stevenson-Chislett*, you have requested a statement as to the practice which has been followed in the Bureau of Internal Revenue on the question of allowing an embezzlement loss to be deducted in the year of discovery where the year of embezzlement is unknown or is barred by limitation.

Pursuant to your request, an inquiry was addressed to Internal Revenue offices in Washington and in selected field offices in the larger cities throughout the country. While the replies to these inquiries do not permit the categorical conclusion that the practice has been wholly consistent, they do manifest a rather clear overtone of permitting embezzlement losses to be deducted only in the year or years of the embezzlement, or not at all.

Replies from a number of these offices do indicate that in some instances, not frequent in occurrence, the loss has been allowed in the year of discovery. However, there appears to be no uniform-

ity of reason advanced ir justification of these allowances in the year of discovery. In a number of larger offices it is indicated that discovery year deductions are sometimes allowed in order to effect settlement. On other occasions the reason advanced is that the loss has in effect been converted into a debt, which is deductible only when it became or was ascertained to have become worthless. One such deduction is said to have been based upon the authority of *Felton* v. *Commissioner*, 5 T.C. 256, 262, acq. 1945 C.B. 3, where the Tax Court said it was unable to find definitely that petitioner's money had in fact been embezzled prior to the date of discovery. One other reason advanced on occasion is the taxpayer's inability to prove the year or years of actual embezzlement, where for settlement purposes deduction has been permitted in the year of discovery. Another office, where the taxpayer shows the total amount embezzled over more than one prior year, not barred by limitation, but is unable to prove how much of the total was embezzled in each of such years, allocates the total embezzled amount among such prior years. However, where the taxpayer is unable to prove the amount of the loss for the actual year or years of embezzlement, the clear majority of replies state that the deduction claimed has been or would be disallowed. Where the statute of limitations has barred the deduction in the year of embezzlement, one office indicates that some allowance may be made in a later year (of discovery) for settlement purposes.

However, in all of the other replies where the inquiry has been specifically put it is indicated that no deduction has been or would be allowed.

Very truly yours,

(Signed) JOHN B. DUNLAP
*Commissioner.*

pdc

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